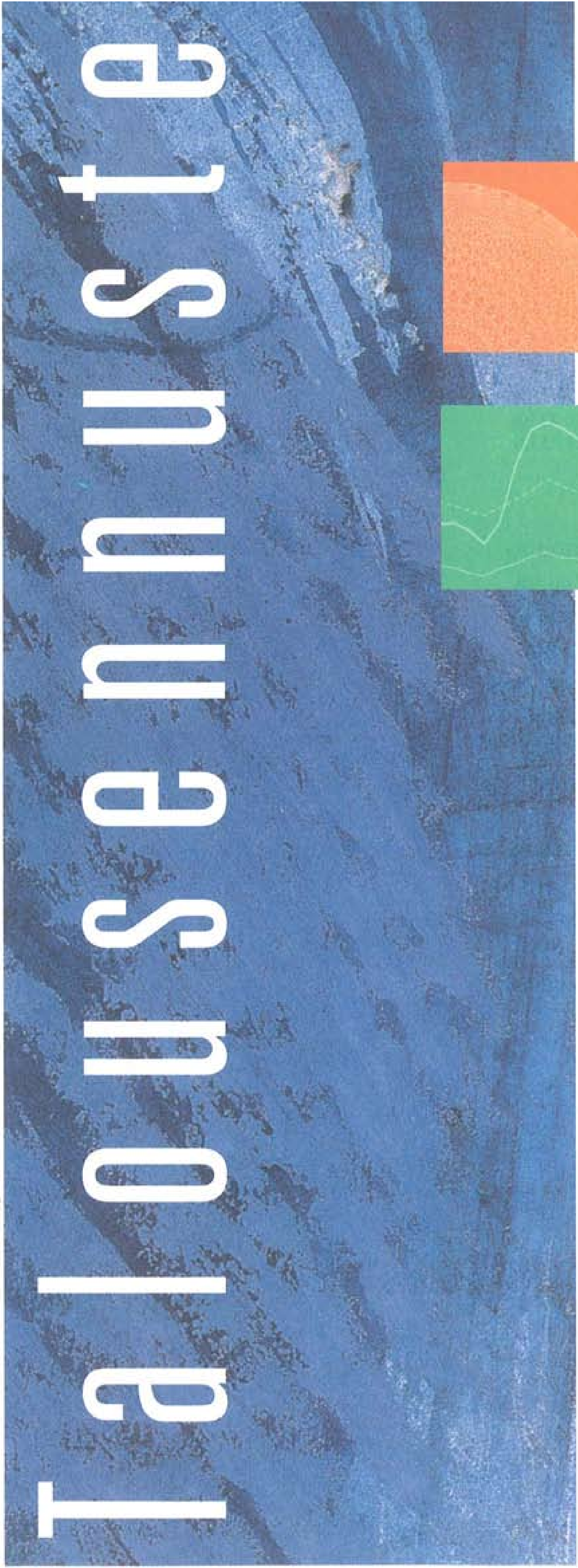


September 11, 2007

Economic Forecast for 2007–2008

Economic growth still robust, but risks grow

Additional information

Chief of forecasting
Eero Lehto
tel. +358-9-2535 7350

Information officer
Heikki Taimio
tel. +358-9-2535 7349

LABOUR INSTITUTE FOR ECONOMIC RESEARCH

Economic Forecast 2007–2008

Economic growth still robust, but risks grow

Finnish GDP will grow this year by 4.2 per cent compared to last year. Next year Finnish growth will slow down to 3.4 per cent. The robust growth stems primarily from the rise in productivity. The purchasing power of wage earners will be boosted next year by sizable wage hikes that have been facilitated by the rise in productivity, serving to reduce the shortfall that has accumulated in recent years. Despite this, the private sector's share of wage income out of total income will not change appreciably next year. The continuation of swift global growth constitutes a precondition for the relatively rapid growth of Finnish total production next year. The spread of the credit crisis spurred by the loose financing of US housing investments is the greatest threat to Finnish economic growth.

European growth continues – private consumption just now starting to recovery

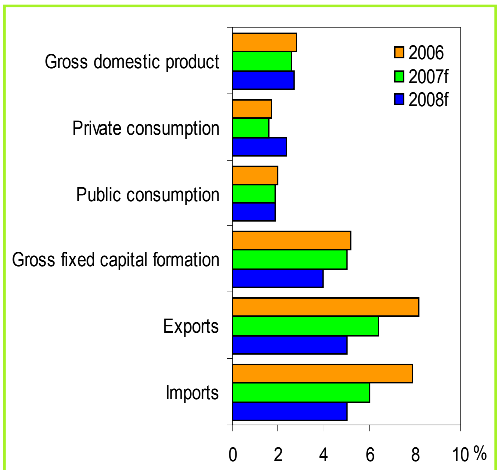
The GDP of the eurozone has grown in the first half of this year by 2.8 per cent compared to last year. The growth figure for the year as a whole will be 2.6 per cent. Economic growth will slow down in the second quarter of this year by only 0.3 per cent compared to the previous quarter and by 2.5 per cent compared to last year. This year growth will still hinge largely on private consumption, which will increase by five per cent compared to last year. Next year investment will climb by four per cent. In the second quarter of this year investment growth slowed down substantially as German residential housing construction subsided due to the discontinuation of tax deductions for interest on loans. The impact of this tax reform will weaken next year. Private consumption will grow this year by 1.6 per cent compared to last year. Next year private consumption growth will accelerate already to 2.4 per cent as the impact of the increase in German VAT subsides, employment improves faster than expected and the real earnings of wage earners rise rather substantially.

Foreign trade will still boost economic growth in the eurozone this year. Next year its growth impact will be positive, albeit somewhat smaller than this year. The GDP of the eurozone will grow next year by 2.7 per cent compared to this year. The continuation of economic growth at such a brisk pace stems largely from the prolongation of the upswing in private consumption. It is also significant that world growth will bolster European growth and that the relatively swift rise in wage levels in developing countries – compared to the narrowing of productivity gaps – toward the level prevailing in the eurozone will improve the price competitiveness of developed countries like those in the eurozone compared to the rapidly growing developing countries.

Employment in the EU and eurozone has also developed favourably. Already in the beginning of this year a faster than expected rise in employment was witnessed, but the rate of the upswing in employment was once again a surprise. This year the unemployment rate of the eurozone will average 7.0 per cent while declining next year to 6.7 per cent.

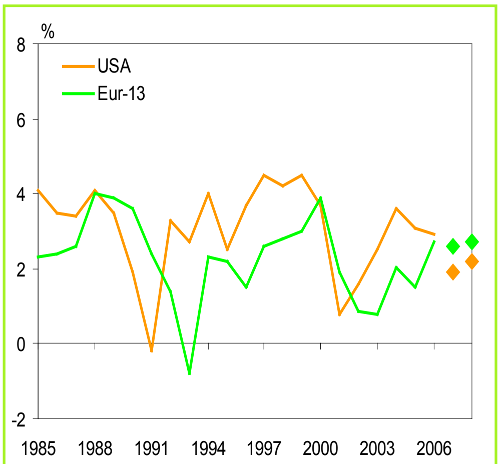
The economic risks of the eurozone are closely linked to the US economy. In the base-case scenario the slowdown in US growth and crisis stemming from the subprime lending, which has raised short-

Eurozone economic growth 2006–2008



Source: Eurostat, PT

Total production in the USA and eurozone 1985–2008



Source: BEA, Eurostat, PT

International economy

GDP growth (%)	2006	2007f	2008f
United States	2.9	1.9	2.2
Euro-13	2.7	2.6	2.7
Germany	2.8	2.7	2.6
France	2.0	1.6	2.2
Italy	1.9	1.9	2.2
EU27	3.0	2.8	2.9
Sweden	4.2	3.4	3.3
United Kingdom	2.8	3.0	2.8
Japan	2.2	1.5	1.5
Russia	6.7	7.5	7.0
China	11.1	11.0	10.0
Source: BEA, BOFIT, Eurostat, Labour Institute for Economic Research			

term interest rates and increased the caution of lenders also in Europe, will dampen European growth relatively modestly. If the crisis deepens, the impact will naturally grow significantly.

Eurozone inflation has remained in the beginning of this year at slightly less than two per cent. This year the price of a basket of commodities excluding food and energy has no longer risen faster than the consumer price index. Inflation in the eurozone will remain this year and next at an average of 1.9 per cent. Wage hikes will spur upward pressure on prices next year while oil and certain other raw material prices will no longer rise as swiftly as previously. It is also significant that German consumer price inflation will slow down as the impact of the hike in VAT passes.

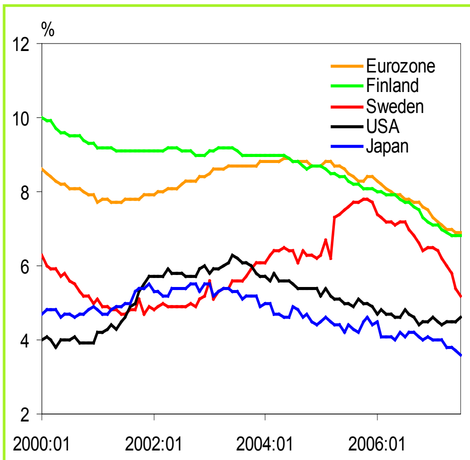
When we made our forecast last March, we forecast that the ECB would raise interest rates one more time by 0.25 percentage points this year. At first this view seemed to cautious, since the ECB had clearly decided to raise interest rate to a normal level as cyclical growth stabilized even though consumer price inflation has remained below two per cent the whole time. Still in the spring the markets expected two more 0.25 percentage point hikes for this year. It has subsequently become known that the crisis stemming from subprime credit has spurred losses also for certain Central European banks, which has fuelled strong demand for liquidity also in Europe. Thus the ECB has had to pump underpriced funds into bank's balance sheets and concentrate on managing the credit crisis.

The subprime crisis has proven to be rather serious, and along with it our financing system has also proven to be rather vulnerable. All this uncertainty will dampen the ECB propensity to raise interest rates. Since it appears that the Federal Reserve will lower its interest rates as a reaction to the credit crisis and slowdown in growth of the real economy, it is more and more apparent that the ECB will no longer raise interest rates during this year. Next year the ECB will keep its key interest rates unchanged. The lowering of interest rates by the Federal Reserve and the turbulence in the financial markets will prevent hikes in interest rates which would be called for by the relatively strong growth in the real economy and the ECB's view regarding the risk of an acceleration of inflation.

Nordic countries stand out

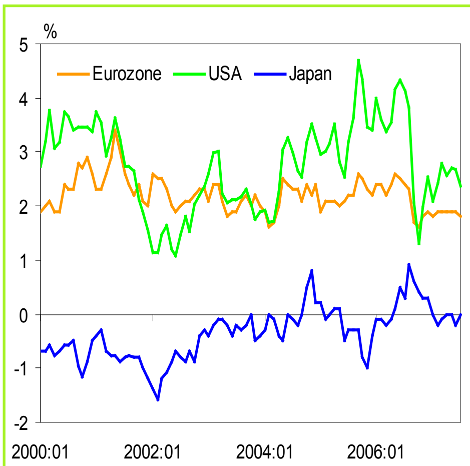
In recent years the Nordic economies have grown appreciably faster than other developed countries. Norway and Denmark are among the richest countries in Europe, and their unemployment rate has dipped below three per cent. Finland's and Sweden's production has grown and

Unemployment in assorted countries 2000:01–2007:07



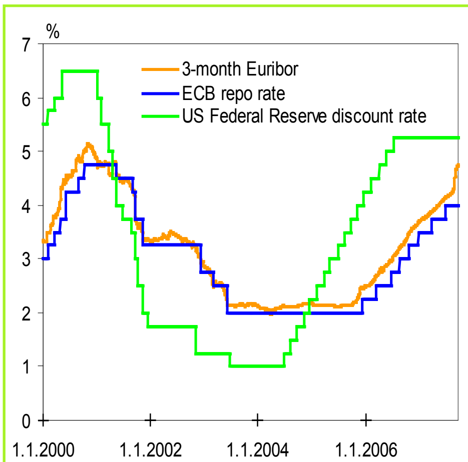
Source: Eurostat

Consumer price inflation in assorted countries 2000:01–2007:07



Source: Eurostat, OECD

Short-term interest rates 3.1.2000–4.9.2007



Source: ECB, Bank of Finland

productivity has risen faster than in other developed countries. Sweden's GDP will grow this year and next year at a rate of almost 3.5 per cent.

Credit crisis dampening US growth

The overheating of the US housing market led to a sharp decline in residential housing construction already in the third quarter of last year, after which it has curbed GDP growth. In the first half of this year GDP grew by only 1.7 per cent compared to last year. In the second quarter total production picked up from the first quarter, but in August the turbulence in the credit market deepened into the subprime crisis, which has made it more difficult to get credit and spurred a sharp drop in housing prices. This has also weakened consumer confidence in August, which cannot yet be seen in the adjacent graph. Now GDP growth is being dampened by the decline in housing investment as well as slackening private consumption.

This August the number of persons employed in the US fell somewhat as high school students exited the labour market. This all goes to show that the credit crisis has slowed US economic growth even further. This year GDP in the US will grow by 1.9 per cent compared to last year. This figure is 0.3 percentage points less than in our forecast last March. Next year growth will accelerate to 2.2 per cent. The credit crisis will curb GDP growth next year also, but the Federal Reserve will seek to alleviate uncertainty in the credit markets and spur economic growth by easing monetary policy. Already toward the end of this year the Federal Reserve will lower its discount rate from 5.25 to 4.75 per cent. Next year interest rates will be gradually lowered to 4 per cent. This declining interest rate scenario will nevertheless require a substantial decline in consumer price inflation from 2.5 per cent, which is indeed likely owing to the slowdown in economic growth.

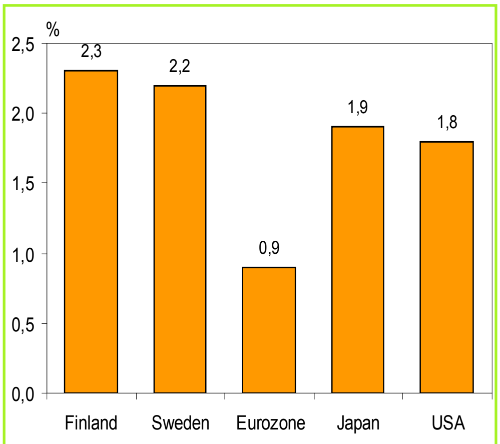
A positive development regarding US economic growth recently is the decline in public fiscal deficit. It appears that the Federal budget deficit will drop this year to 1.2 per cent of GDP from last year's 1.9 per cent. Even more significant than this is the strengthening of US foreign trade as the relatively brisk growth in the global economy sustains the upswing in exports and the considerable weakening of domestic demand curbs the growth in imports. The US trade deficit in goods and services will nevertheless still be about five per cent relative to GDP this year.

Asian currencies decoupled from the dollar

From the standpoint of the equilibrium of the international economy, of key importance is how the dollar, euro and Asian currencies move with respect to each other. The elimination of the US trade deficit will require a weakening of the dollar, which is the direction it has been going, for example, against the euro. For Europe, the weakening trend of the dollar has been problematic because Asian countries like Japan have either intervened in currency markets or like China they have pegged their currency to the dollar via administrative means. Thus the Asian currencies have also weakened against the euro even though the Asian countries have mostly been running trade surpluses with European countries.

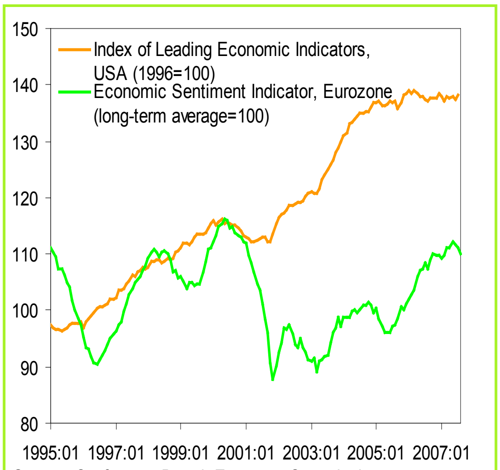
During recent years the Asian currencies have nevertheless begun to relax their dollar pegs. Asia has evidently already become such a large market area that these countries do not have to bolster their exports to the US with actions that strengthen the dollar. On the other hand, the subprime crisis has increased the caution of Asian countries

Average productivity of labour during 2001–2008



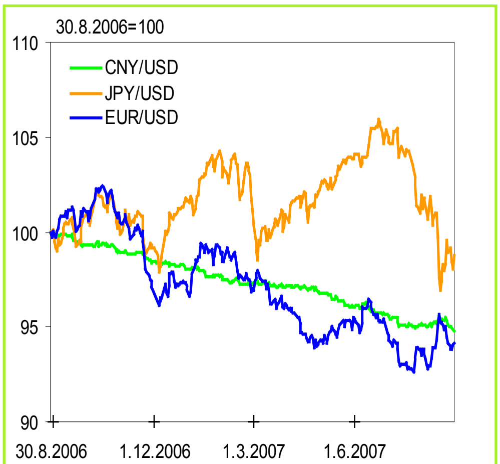
Source: BEA, Eurostat, Konjunkturinstitut, OECD, Statistics Finland, PT

International leading indicators 1995:01–2007:08



Source: Conference Board, European Commission

Exchange rates 30.8.2006–30.8.2007



Source: ECB

when they consider investing their trade surpluses in dollar-denominated investments.

Inflation accelerating in China and EU's new member countries

China's GDP will grow this year by 11 per cent and next year by 10 per cent. The revenues generated by the foreign trade sector are beginning to bolster the income formation of other sectors. When the wage level of the domestic market sectors rise without corresponding productivity improvements, their prices will also have to climb. As evidence of this, China's consumer price inflation picked up this summer already to 5.6 per cent. The same phenomena of rising price levels can be witnessed also in the EU's new member countries. For example, Estonia's consumer prices have in recent months climbed by slightly over 6 per cent compared to last year.

The relatively high world market prices of oil and gas guarantee Russia a sizable trade surplus. In this respect the situation will not change in the next few years. Russia's GDP will grow this year and next at a rate of about seven per cent.

European and Asian growth will boost Finnish exports

Last year Finnish export volume growth accelerated until the second quarter, after which the rate of growth slackened off toward the end of the year, meaning that the base of comparison will generate negative growth figures. At the beginning of this year exports picked up again and knowing that there were the relatively modest figures in the second half of last year we can project that goods exports will accelerate toward the end of the year. The volume of goods and services will grow this year by 6.2 per cent compared to last year.

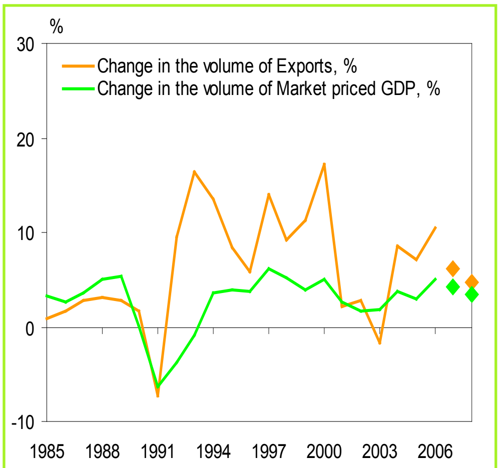
Starting last year Finnish exports to EU countries have increased faster than exports on average. This is attributable to the pick-up in European economic growth, which will boost exports still next year when exports as a whole will grow by 4.7 per cent. Information about the strong order books of the technology industry substantiate the view of continued relatively swift growth.

This year a favourable trend has been witnessed where Finnish exports to East Asia and India have grown substantially faster than imports. It remains to be seen whether there will be a change in this trend so that Finland's large trade surplus with East Asian countries will begin to decrease. Asian trade may level off as the impact of the contraction of output in the electronics assembly industry in Finland tapers off and the acceleration of inflation due to China's and India's rapid rise in nominal wages erodes these countries' competitiveness.

The volume of Finnish imports will grow this year by 4.4 per cent compared to last year. Next year the rate of import growth will decrease to 3.8 per cent in the wake of the slowdown of GDP growth. On the other hand, import growth will be sustained by purchases of machinery and equipment for Finland's new nuclear power plant, prompting a narrowing of the growth differential between exports and imports.

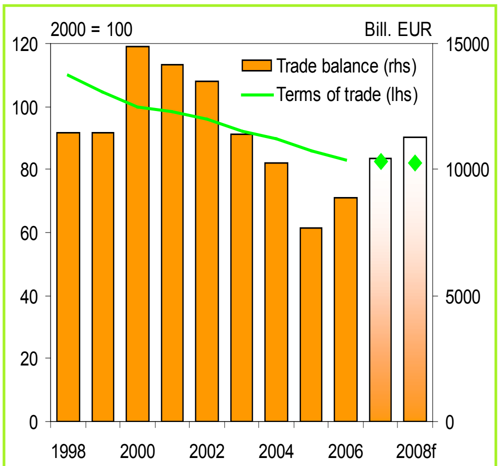
Import prices will rise this year by about three per cent compared to last year, i.e. slightly less than a percentage point faster than export prices. Next year the rate of increase in foreign trade prices will slow down, but the terms of trade will continue to weaken somewhat. The

Change in total production and exports 1985–2008



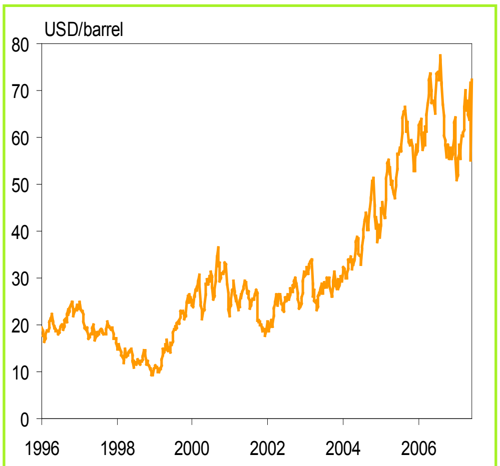
Source: Statistics Finland, PT

Terms of trade and trade balance 1998–2008



Source: Statistics Finland, PT

World market price of crude oil (BRENT) 1996–2007



Source: Statistics Norway

balance of trade will improve this year to over EUR 10 billion and next year it will increase by almost EUR 1 billion from this year's level.

Technology industry showing strong performance

Boosted by the over 10 per cent growth in output of the technology industry, the manufacturing industry will expand this year by almost 7 per cent and next year by 5 per cent. The strong performance by industry will spur swift growth in services over a broad front. Wholesale and retail trade and business services will grow by about 5 per cent this year and 4 per cent next year. Transport and storage will grow this year and next year by slightly less than 3 per cent while personal services, including public services, grow by some 2 per cent. This year the production of hydropower, which reacts strongly to swings in Norwegian and Swedish output, will decline appreciably from last year while next year the value added by the over-all electricity, gas and water utilities is expected to normalize to its two per cent growth path.

Improvement in employment exceeded forecast

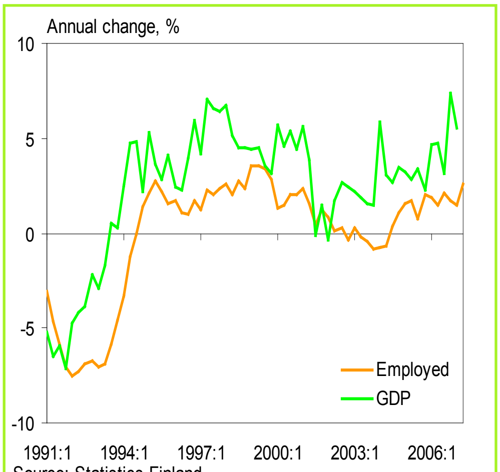
The number of unemployed persons grew in January-July by 50,000 persons compared to last year. Jobs have been created the most in technical and business services but also construction, wholesale and

Key forecasts

	2006	2007f	2008f
Unemployment rate (%)	7.7	6.8	6.3
Unemployed (1 000)	204	181	169
Employed (1 000)	2443	2491	2517
Employment rate (%)	68.9	69.8	70.3
Inflation, consumer price index (%)	1.6	2.5	2.6
Wages, index of wage and salary earnings (%)	3.0	3.3	4.7
Real disposable income of households (%)	1.8	3.2	2.8
Current account surplus (Bill. €)	7.8	9.1	10.0
Trade surplus (Bill. €)	8.9	10.4	11.3
Central government financial surplus			
Bill. €	1.4	2.3	2.2
% / GDP	0.8	1.3	1.2
General government financial surplus			
Bill. €	6.2	8.3	8.8
% / GDP	3.7	4.7	4.7
Emu debt			
% / GDP	39.3	37.3	35.5
Tax rate (%)	43.5	43.1	42.7
Short-term interest rates (3-month Euribor)	3.1	4.2	4.2
Long-term interest rates (10-year gov't bonds)	3.8	4.3	4.3

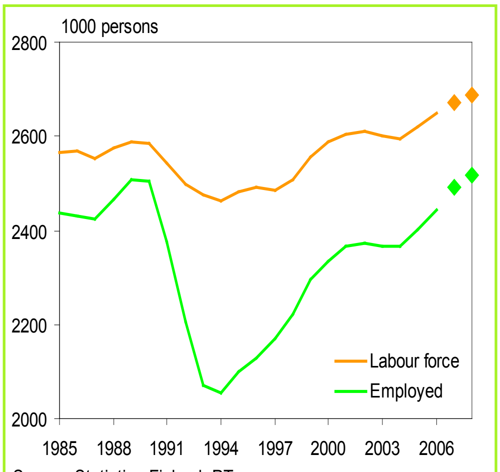
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research

Employment and gross domestic product 1991:1–2007:2



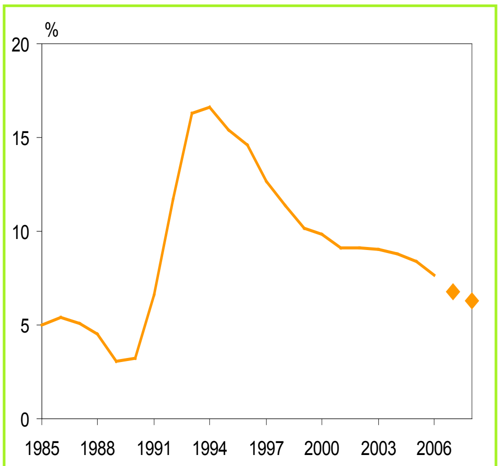
Source: Statistics Finland

Supply of labour and employment 1985–2008



Source: Statistics Finland, PT

Unemployment rate 1985–2008



Source: Statistics Finland, PT

retail trade as well as lodging and restaurants. The improvement in employment has encouraged working aged persons to enter the job market. The workforce grew in the beginning of this year by 25,000 persons despite the sluggish growth in the working age population. Along with the improvement in the labour market situation the unemployment rate fell in the beginning of this year more than expected. It is also noteworthy that the number of long-term unemployed fell in the beginning of the year by 9.4 per cent compared to last year.

In the end of the year jobs will be created at almost the same rate as in the beginning of the year: the number of employed persons will grow this year by 48,000 persons while the unemployment rate falls to 6.8 per cent. Also next year the labour market developments will continue to be positive owing to the swift albeit slightly lower rate of growth this year. The number of employed persons will grow next year by 26,000 persons and the workforce by 14,000 persons, so that next year the unemployment rate will be 6.3 per cent and the employment rate will be 70.3 per cent. The hours worked according to the labour force survey by Statistics Finland will grow this year by 1.6 per cent and next year by 1.1 per cent.

The IMF expressed its concern this spring in its report on Finland's high youth unemployment rate. Finland's youth unemployment rate has nevertheless fallen appreciably recently: the seasonally adjusted rate in August was 16.1 per cent, which is 2.8 percentage points less than a year ago. The level is already near the average of the EU-15 countries. In addition it has been noticed that in Finland also full time students enter the job market in spring and are classified as unemployed. Last year there was an average of 37,000 unemployed students, i.e. over half of the 61,400 youth unemployed. Without this group the youth unemployment rate in Finland last year would have been 9.4 per cent, which is evidently less than the EU-15 zone average even after unemployed students have been eliminated from the EU figures.

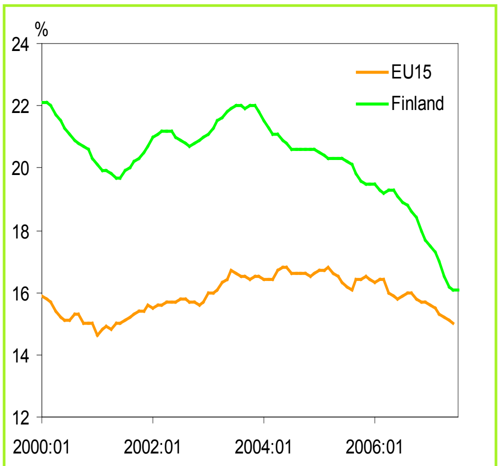
Wage settlements more decentralized and greater portion of wages agreed locally

This year the level of wages will rise by 3.3 per cent of which the share of contract wages is two per cent. Companies' favourable profitability trends have sustained growth in bonus pay and other forms of wage drift. Economic growth has boosted the demand for labour and this year the wage bill will grow by 5.2 per cent. In this situation average hourly wages will rise faster than the level of wages.

This autumn the comprehensive incomes policy settlement will expire and labour union level negotiations will define wage developments. For the time being, only a few labour unions have reached settlements. New features include agreements on certain matters at the local level and one-time compensation paid at the beginning of the contract period. We project that the local pay increases will reduce wage drift significantly. For this reason the wage index will rise by 4.7 per cent in 2008. The contract wage index's share of this is 4 percentage points. Average hourly wages will rise by 4.9 per cent.

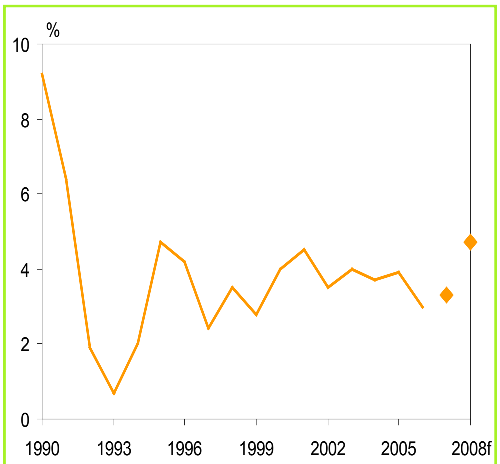
This year the wage bill will grow substantially more slowly than the operating surplus of the private sector. The functional income distribution has weakened and the share of wages within companies' value added has fallen to the same level as that prevailing during the boom in the late 1990s. According to our forecast the wage bill will grow in 2008 by 5.9 per cent, i.e. at approximately the same rate as the operating surplus. The share of private sector wages will not change appreciably from that prevailing this year.

Youth unemployment rate in Finland and EU15-countries 2000:01–2007:07



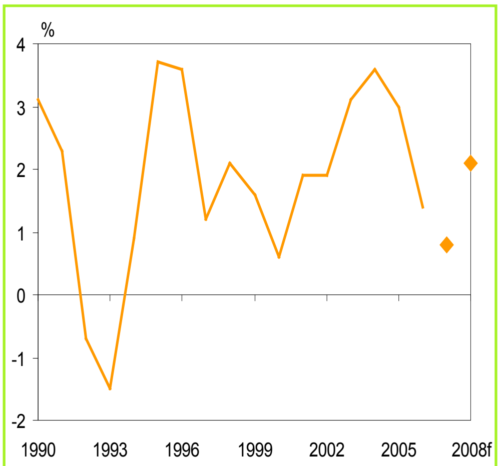
Source: Eurostat, Statistics Finland

Change in level of earnings index 1990–2008



Source: Statistics Finland, PT

Change in real earnings 1990–2008



Source: Statistics Finland, PT

Household property income will grow at a brisk pace this year. Rising interest rates will increase the popularity of deposits while the stock market investments and dividends of households will decrease correspondingly. On the other hand, the interest expenses of housing loans will rise by 40 per cent. As an effect of rising prices the income of both agriculture and forestry will grow. Next year the growth of these incomes is predicted to level off. This year the income development of households was boosted with income tax cuts, but next year only minor adjustments to the tax schedule of wage earners will be made. We predict that the real disposable income of households will increase by 3.2 per cent this year and 2.8 per cent next year.

Households still borrowing even though consumption growth is slowing down

Private consumption has already grown faster than average for several years. Growth has been supported by a strong consumer confidence and decreasing interest rates on loans. Last year consumption growth far exceeded the growth of disposable income. Even though private consumption growth will slow down to 3.5 per cent, households will continue to become more indebted. Car sales have levelled off and purchases of other long-term durable goods will increase more slowly than before. Next year consumption growth will decelerate to 3 per cent. The course of these developments is influenced by the upturn in interest rates on loans and growing debt servicing expenses.

Demand and supply

	2006	2006	2007f	2008f
	Bill. €	Percentage change in volume (%)		
Gross Domestic Product	167.1	5.0	4.2	3.4
Imports	65.7	8.3	4.4	3.8
Total supply	232.7	5.9	4.3	3.5
Exports	74.4	10.4	6.2	4.7
Consumption	122.2	3.3	2.8	2.6
private	85.9	4.3	3.5	3.0
public	36.3	1.0	1.3	1.5
Investment	32.0	4.1	5.6	4.4
private	27.9	5.6	5.8	4.5
public	4.1	-5.3	4.0	4.0
Change in stocks	4.2	-8.3	1.7	1.7
Total demand	232.7	5.9	4.3	3.5

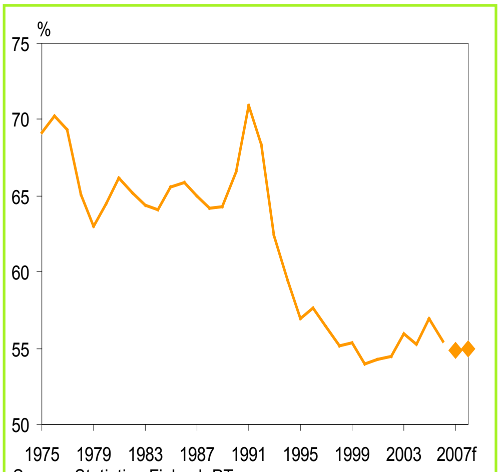
Source: Statistics Finland, Labour Institute for Economic Research

Next year's consumer price inflation 2.6 percent

This year inflation has been clearly faster than we predicted in spring. Prices of dwellings climbed more and their rise lasted longer than we had estimated. This year's inflation is 2.5 percent and the inflation rate will continue to accelerate in the rest of the year. The effect of higher interest rates on the cost of living and housing loans will be almost a percentage point this year. For this reason the harmonized consumer price index, excluding interest rates and dwelling prices, will rise by only 1.6 per cent this year.

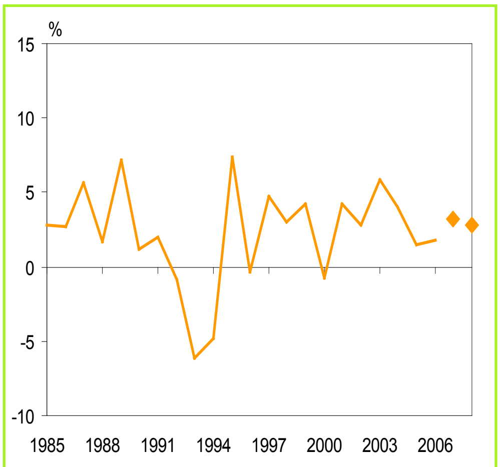
Next year the rise of consumer prices will change form. The taxation decisions of the government will play a significant role. A hike in

Functional distribution of income in business activities 1975–2008



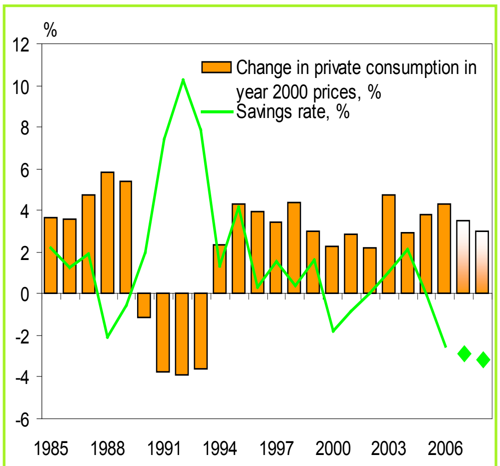
Source: Statistics Finland, PT

Annual changes in households' real disposable income 1985–2008



Source: Statistics Finland, PT

Private consumption and savings rate 1985–2008



Source: Statistics Finland, PT

the alcohol tax will cause 0.3 percentage points of additional inflation, taking into account its effect on the value-added taxes and prices in bars and restaurants. The direct inflation effect of the electricity and fuel tax will stay slightly smaller than this, but their indirect upward pressure on personal and goods transport expenses is difficult to estimate. The upswing of interest rates on loans is starting to decelerate, and we estimate that in comparison to this year inflationary pressures caused by them will ease by about 0.4 percentage points in 2008. Additionally, the rise in dwelling prices will slow down, but the price of food will correspondingly increase. When all this is taken into account the harmonized consumer price index (Eurostat) is estimated to rise by 2.1 per cent in 2008. The increase in consumer prices will amount to 2.6 per cent. No upward or downward pressures are anticipated in the price of crude oil on an annual level. The pricing power of domestic market companies has grown in the present market situation. Indeed there is a risk that inflation will accelerate from the forecast as businesses transfer expense rises to their selling prices.

Residential housing construction falling and production capacity expanding

Private investment grew by 5.9 per cent in January through June in comparison to the previous year. Office, retail and industrial construction and civil engineering construction have increased clearly as dwelling construction has simultaneously subsided. In light of construction starts and construction permits granted it can be presumed that these trends will continue also during the rest of the year. On the whole, private investment is predicted to increase by 5.8 per cent this year in comparison to last year.

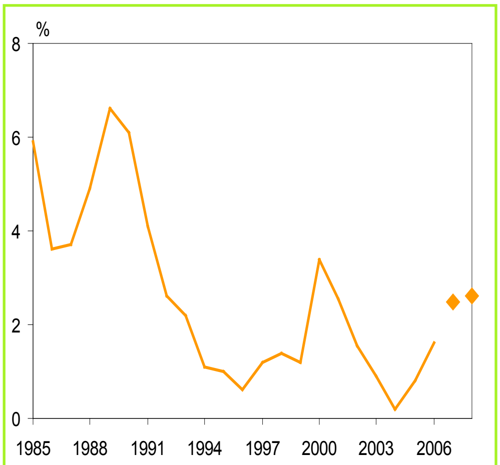
Estimating investments during the ongoing year and in particular next year is made more difficult by the timing of the Olkiluoto nuclear power plant investments. On the one hand, making projections is more difficult also because the government might postpone large road projects to a later point in time. It is likely, however, that more equipment relating to the nuclear power plant project will be delivered next year than this year and that civil engineering construction will continue to grow swiftly. Hence private investments will grow by 4.5 per cent compared to this year, i.e. at a rather fast pace despite the weakening of economic growth.

Public sector surplus this year 4.7 per cent

This year robust growth in employment, corporate revenues and private consumption will spur a rise in central government tax revenues by slightly over 5 per cent despite cuts in income taxes. The dividend revenues received by the central government will rise already to EUR 1.6 billion. The central government's surplus will climb to almost EUR 2.3 billion as its revenue sharing with the municipalities increases somewhat more slowly, by about four per cent, and growth in central government consumption and investment expenditures remains modest.

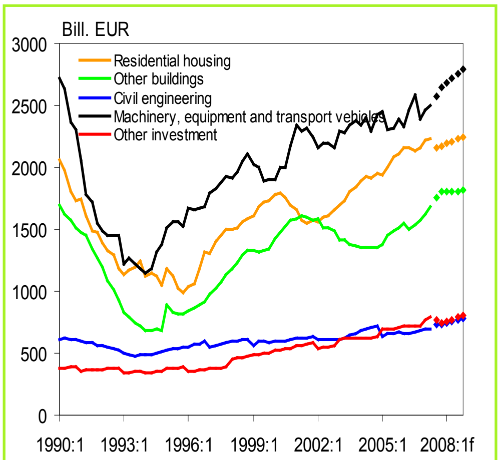
The slow growth in revenue sharing received by municipalities will be offset this year by shifting the earned income deduction from municipal taxes to central government taxation, which will boost growth in tax revenues somewhat. In the first half of this year municipal income taxes were growing by 7 per cent and approximately the same growth rate is expected for the year as a whole. The municipalities'

Change in consumer prices 1985–2008



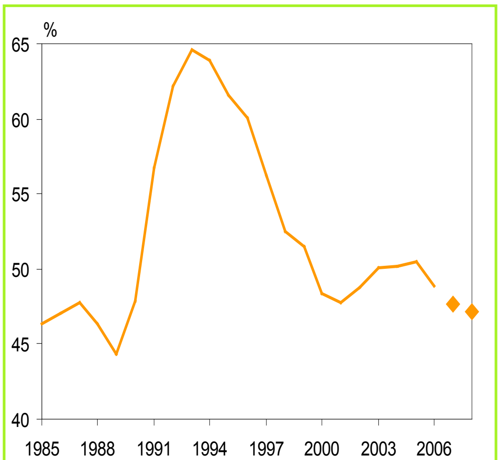
Source: Statistics Finland, PT

Investment by sub-components 1990:1–2008:4



Source: Statistics Finland, PT

Public expenditures as percentage of GDP 1985–2008



Source: Statistics Finland, PT

consumption and investment expenditures will rise considerably this year, but their financial position will improve by EUR 200 million as they end up running a slight deficit. Still in 2005 the municipalities were running a deficit of over EUR 1 billion.

The rate of growth of contributions to pension institutions and other social security funds will fall from 7.3 per cent to 5.3 per cent, i.e. almost the same as the growth in the wage bill. This is attributable to the fact that the pension insurance contribution rate will remain approximately unchanged. On the other hand, the dividend income of pension institutions will increase substantially. As employment improves and the rise in the retirement age curbs growth in social benefits, the surplus of this sector will rise by EUR 900 million to EUR 6 billion.

The overall surplus of the public sector will climb this year by a percentage point to 4.7 per cent of GDP, and the EMU debt ratio will subside to 37.3 per cent. Total taxes as a percentage of GDP will subside by 0.4 percentage points to 43.1 per cent.

Central government tax revenues will be subject to several contradictory trends in 2008. The impact of raising alcohol taxes and easing of inheritance taxes will be rather small and tend to offset one another. The slowdown in private consumption will be felt in value added tax revenues. A EUR 300 million hike in energy taxes will raise indirect taxes considerably. On the other hand, inflationary adjustments of wage and pension income taxation as well as the slowdown in the growth of corporate tax revenues will dampen the growth in income tax revenues. Total central government taxes will increase by about a percentage point more slowly than this year. While growth in the central government's investment expenditures and revenue sharing with municipalities will accelerate substantially, the central government's surplus will decrease slightly but still remain around EUR 2 billion.

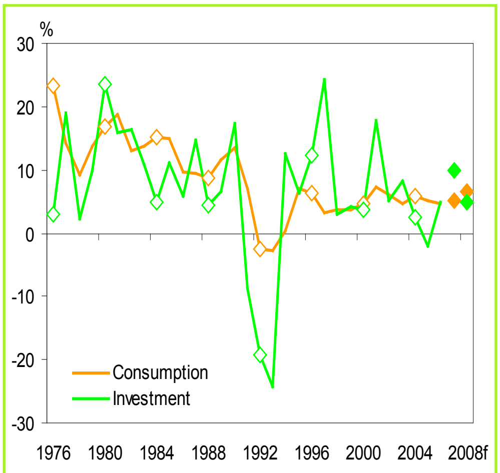
The growth in tax revenues of the municipalities will slow down next year. In the forecast it is assumed that the consumption expenditures of municipalities will rise modestly and municipal tax rates will rise on average by a tenth of a per cent. Growth in state revenue sharing will exceed 8 per cent, so that municipal finances will already reach a balance.

The surplus of pension institutions and other social security funds will grow this year by EUR 0.5 billion. Pension insurance contribution rates will rise and growth in the wage bill will accelerate. On the other hand, increases in national pensions and other benefits will increase the expenditures of this sector.

Next year, total taxes as a percentage of GDP will continue to rise by 0.4 percentage points. The EMU surplus of the general government will remain unchanged at 4.7 per cent of GDP and the EMU debt ratio will continue its descent as it falls by 1.8 percentage points. Both this year and next the public sector's surplus will exceed 4 per cent, which according to the Ministry of Finance is the level the public sector must reach in order for Finland to be able to cope with the costs of its aging population in the future.

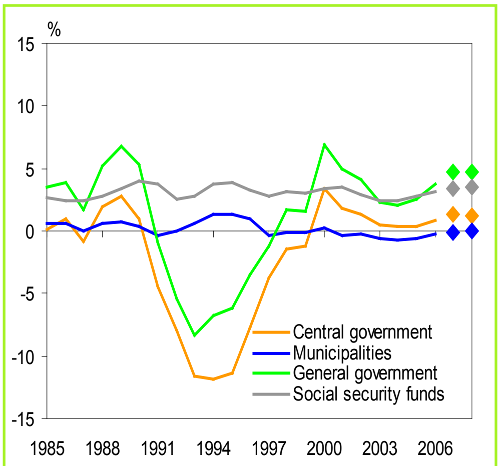
As the adjacent tax ratio graph illustrates, the cuts in earned income taxation, which have gained great attention in recent years, have not spurred a very steep decline in total taxes as a percentage of GDP. Another significant observation over a longer time horizon is that social insurance contributions and municipal taxes relative to GDP have decline while the central government has returned to the level prevailing in the mid-1990s.

Municipal consumption and investment 1976–2008



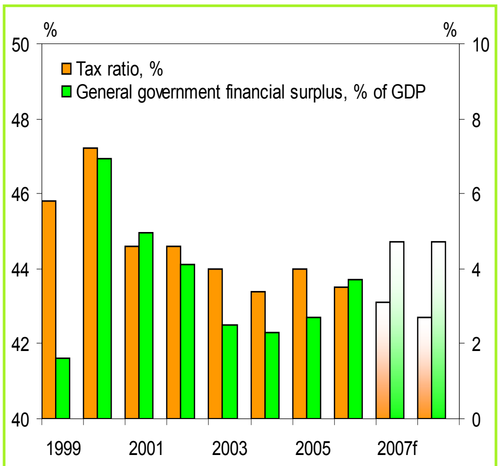
Source: Statistics Finland, PT

General government financial surplus as percentage of GDP 1985–2008



Source: Statistics Finland, PT

Public finances 1999–2008



Source: Statistics Finland, PT

Model simulation about impact of slowdown in European growth

The model of the Labour Institute for Economic Research has been used to simulate a situation where European economic growth is substantially lower than in the basecase scenario. It was made based on an assumption that each European countries' GDP growth this year and next year is one percentage point slower than our forecast. This would affect Finnish exports and via this channel the rest of the economy so that GDP would grow this year by 0.3 and next year 0.2 percentage points more slowly than in the basecase scenario. The growth of exports would slow down this year by 0.8 and next year by 0.6 percentage points compared to the basecase scenario.

Slowdown in European economic growth

Percentage points	2007	2008
Impact on GDP growth	-0.3	-0.2
Impact on export growth	-0.8	-0.6
Source: PT		

Government in crossfire from interest groups: did it forget to promote employment?

The development of the Finnish national economy is marked by favourable economic trends, a faster improvement in productivity than in other developed countries and a gradual transition from problems with unemployment to growing pains stemming from bottlenecks in the labour force. Not only in a medium-long period of 5-10 years but already now economic policy decisions are being limited by the foreseeable shifting of large age groups into retirement.

The key issue in the government's fiscal policy, which above all concerns decisions on the next few years' budget taxation and spending policies, is the desire to smoothen cyclical economic trends and prepare for the ”ageing crisis” by restraining the growth of public expenditures close to the strictness called for by civil servants in the Ministry of Finance. The new government coalition's own political promises and the demands of its closest interest groups have also not gone completely unfulfilled. The risky decisions of freeing businesses and farms from the inheritance tax can be seen as a service to the interest groups without larger social merit or even as being totally unbeneficial actions on a grand scale. The abundant supporting of agricultural investment with budgetary funds can also be classified in a similar manner. The substantial increase in student aid or the basic portion of the national pension and the taxation relief of pensioners can instead be seen as steps in the right direction to support people with the lowest incomes. This low-income support will be partially offset by hikes in basic service charges.

The taxation policy of the government has so far not promoted the demand for labour or the activation of the working-aged population to participate in the labour market. The tax relief of pensioners even acts as an incentive for retirement. In order to prevent this, the tax cuts of pensioners should have been carried out simultaneously with the corresponding income taxation cuts of wage earners.

The government's increases in fuel, electricity and alcohol taxation from the beginning of next year onward can be seen as steps in the right direction concerning the environmental and healthcare policy. However, these tax hikes significantly accelerate inflation and in doing so cut household purchasing power. Additionally, municipal service charge hikes will be carried out later, which will curtail the livelihood of people with the lowest incomes, for example single parents and people living on the national pension. They will also in part reduce the support directed from the central government to the municipalities and as such weaken the position of municipalities in dire financial situations. Hikes in municipal payments should indeed not be carried out.

Cutting carbon dioxide emissions specifically by raising the electricity tax is not a very efficient means because of the price inelasticity of electricity consumption. This action is not desirable from the standpoint of income distribution either. The same fiscal effect would be easily achieved by passing a tax on the existing nuclear and hydropower capacity, which would in part cut the additional revenues which the transition to market pricing has brought to these electricity producers, and which the start of the emission trading and emission rights becoming more expensive is still expanding.

Lowering the value added tax on food down to 12 per cent going into effect at the start of October in 2009 will be most beneficial for people with low to medium incomes. The greatest risk of this action will most likely concern not so much the margins of retail sales, but rather the widening of the value-added of the particularly centralized food industry enjoying some sort of domestic market protection.

The strict spending frameworks of the central government, where the real growth of framework expenditures is restricted to 1.6 per cent annually on average in the period of 2007-2011, will in part reduce the central government's opportunities to support the improvement in the quality level of basic services and making education and research more effective required by the changes in business life.

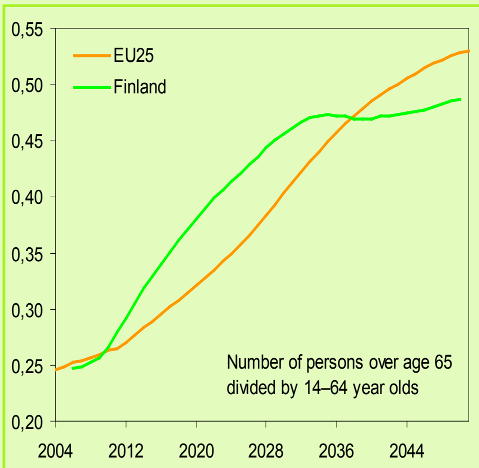
However, the spending frameworks do not at all cover the rise of cost levels. The state revenue sharing with municipalities, whose expense level is measured in the form of a special state revenue sharing index, grow automatically as municipal wage levels rise. The central government covers 30 per cent of health care expenses. Therefore a 5 per cent rise in municipalities' health care expenses would automatically increase state revenue sharing already by about 200 million euros. It seems as though some subsequently want to call this compensation ”the state's female wage support”. Whether the state is going to grant any further support following the wage settlement of the municipal sector is unclear for the time being.

Burden of costs from ageing cannot be avoided

The preparations for the large age groups moving toward retirement, and the age groups of employed persons becoming smaller from 2009 onwards is already affecting fiscal policy. According to the analysis of the Ministry of Finance, the public sector should run an average of 4 per cent surplus from 2010 onwards, so that the promised pensions would be able to be paid and the expenses of the social and healthcare demands of the ageing population could be taken care of.

The lack of sustainability could be somewhat reduced by the fact that the employment rate has already risen to a higher level than the Ministry of Finance supposed it would at the end of the decade. Before long even the unemployment rate can drop clearly under 6.5 per cent, which is the level the Ministry of Finance assumes in its calculation all the way until 2050. Additionally, in the fresh population estimate of Statistics Finland, on which the sustainability calculation was not yet based on, the birth rate has been revised upwards somewhat, and net immigration even more. This could make the estimate of required surplus smaller to some extent. All in all, the better than predicted development of employment or a population growth faster than anticipated will not significantly decrease the economic costs from ageing.

Ratio of elderly persons 2004–2051



Source: Statistics Finland, PT

However, the rise of the ratio of elderly persons is characteristic of all of Europe and Japan. Although the amount of working aged people will start to decrease earlier than in the rest of Europe on average, ageing trends will lift the average ratio of elderly persons from 2038 onwards over the corresponding ratio in Finland so that the gap will keep growing. Later, when approaching 2050, the situation in Europe will already be clearly worse than in Finland on average.

Rather different approaches to the ageing problem have been presented. The Research Institute of the Finnish Economy (Etla) has introduced changing the pension system so that pension levels would not be determined ahead of time. Instead a maximum limit would be set for pension payments and the level of the pension would let be determined the imputed profit rates of the pension funds. In the system proposed, the payment limit would eliminate the risk associating with the varying pension payment, but would entail a risk affecting the livelihood of pensioners in its place. The risk would then fall clearly more on the pension recipient than on its payer. However, due to the inferior risk bearing ability of employees in comparison to employers, this change would increase the system's net expenses.

In relation to this, limiting the amount of compulsory pension payments has also been suggested, which would make room for a more individual and voluntary pension saving. However, by shifting to individual pension saving, the expense savings of gathering risks together would be lost. At the same time the social insurance aspect of the employment pension and the livelihood of those beneficiaries in its weakest and most threatened position would be undermined. Likewise the more individual covering of health care expenses in the form of special health accounts, which also have been proposed, would weaken the system's ability to reduce the risk associating to health care expenses.

Dropping the level of future pensions from the present level is above all aimed at restricting labour expenses. This saved expense might however remain quite small, because employees would have to compensate for the weakening of the pension benefit promised by the pension system with individual additional saving, which would in part increase the wage demands of employees.

A system where the family takes care of the elderly is not necessarily easier on society than a system where society's responsibility for care is of key importance. Services provided by society promote a high propensity for the working-aged population to participate in the labour force and through this reduce the tax burden associated with funding the systems.

No sort of breakdown in ethical norms is likely to be expected where the elderly would simply be left on their own. However, it is probable that weakening the general taxation-based system so that subjective increases would indeed undermine the security of elderly persons who for some reason have not prepared themselves or whose relatives are unable to take care of them for various reasons. Moreover security based on individual saving would most evidently increase income differences between the elderly. This is hardly desirable.

All in all, it is difficult for the working-aged population to avoid the growing burden facing it in the future when the relative size of the elderly population grows. This burden can most efficiently be reduced by furthering employment among working aged persons, raising average retirement ages and by increasing the funding of the employee pension system. Furthering all of these goals simultaneously is nevertheless difficult. For example, shifting part of the payment burden on to the presently working-aged population by front-ended increases in employee pension payments would weaken the conditions to foster the level of employment. As long as the economy has potential for an increase in employment – which Finland should still possess in abundance – the finance policy should primarily promote employment.

Because the state together with employment pension institutes practically is in charge of managing the whole problem of the number of working aged persons becoming smaller, the strengthening of the net funding position of the central government can in turn be seen as preparing for the problem brought about by ageing of the population. Indeed the central government has better possibilities for strengthening the whole public economy without significantly tightening labour taxation. This would require tightening such taxes which have a weak effect on the cost of labour, and in turn correspondingly easing labour taxation. In light of the actions and promises of the government up to this point, the fiscal policy will be directed moderately towards strengthening the funding position of the public sector for the government's whole term. Instead no pure efforts to promote employment by changing taxation structures are in sight.